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Reducing Structural Dominance and Entry Barriers in Russian Industry

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The absence of new business in Russia is striking. Reforms to make Russia more competitive should start with eliminating regulatory and institutional barriers to the entry of new competitors.

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Summary findings

Many industrial firms in Russia have undergone changes in ownership, but relatively few have been competitively restructured. Using survey and other data, Broadman suggests that much of Russian industry is immune from robust competition because of heavy vertical integration, geographic segmentation, and the concentration of buyers and sellers in selected markets.

Moreover, regulatory constraints protect incumbent firms from competition with new entrants, both domestic and foreign.

Broadman sketches a reform agenda for Russia's post-privatization program, which emphasizes the restructuring of anti-competitive structures and the reduction of barriers to entry. Broadman's proposed reform agenda calls broadly for strengthening Russia's nascent rules-based framework for competition policy to reduce discretion, increase transparency, and improve accountability.

This paper — a product of the Poverty Reduction and Economic Management Sector Unit, Europe and Central Asia Regional Office — is part of a larger effort in the region to assess structural reform in Russia. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Sandra Craig, room H4-166, telephone 202-473-3160, fax 202-522-2753, email address scraig@worldbank.org. Policy Research Working Papers are also posted on the Web at www.worldbank.org/research/workingpapers. The author may be contacted at hbroadman@worldbank.org. May 2000. (18 pages)

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I. INTRODUCTION

The development of a competitive private sector business environment in the industrial sector[1] is essential to the sustainability of Russia's growth. Since the start of reforms in 1992, significant progress has been made in many areas of the economy. Russia's industrial sector is one where price controls have been lifted on 90% of wholesale and retail goods, and most state owned enterprises (SOEs) have been privatized, although some key SOEs have yet to be fully or partially divested.[2]

Yet Russia had not undertaken significant restructuring of dominant firms or eliminated non-economic barriers to entry *before* price liberalization or privatization was instituted. Horizontal and vertical dominance among incumbent firms, and barriers to entry by new businesses are considerably more pronounced in Russia's industrial sector relative to many other transition economies (a significant exception being China[3]). The relative absence of new businesses in Russia is particularly striking. While many enterprises have experienced ownership change, the industrial configuration determined by administrative fiat and central planning during the Soviet era has yet to give way to a regime of enterprise structure, conduct and performance engendered by competitive market forces.

It appears that there remains considerable potential for abuse of market power in Russia, not only in the infrastructure monopoly sectors--a point that is widely acknowledged and for which policy initiatives form a significant part of the Government's structural reform agenda--but also in elements of the manufacturing sector. In point of fact, many industrial firms are effectively immune to robust competitive market forces due to structural and administrative impediments. These impediments include significant seller (and buyer) concentration--horizontal dominance--in select regional markets; there is also a high degree of vertical integration and exclusive buyer-seller relationships in certain industrial sectors and pervasive regional geographic segmentation. Equally important, regulatory and institutional entry barriers protect many incumbent firms in dominant markets from new competitors or even the threat of potential competitors, both domestic and foreign.[4]

Excessive horizontal and vertical consolidation and high entry barriers in Russia's industrial sector have several consequences: (i) high prices, reduced output and diminished product and service quality--all of which act as disincentives for rechanneling enterprise assets to higher use values and greater productivity; (ii) diminished incentives for inter-regional trade among regions, thus retarding formation of a unified economic space; (iii) reduced business investment from foreign sources; and (iv) stifled innovation and technological advancement. Reforming anti-competitive horizontal and vertical structures in the manufacturing sector and reducing barriers to entry for new competitors should be key items on Russian post-privatization agenda for enterprise reform.

This paper assesses the incentives and constraints on enhancing structural aspects of inter-enterprise competition and on reducing barriers to entry in Russia's manufacturing sector and recommends policies for the Russian authorities. The central conclusions are that in an economy as large as Russia's that is undergoing a complex transition, the appropriate competitive horizontal and vertical restructuring of industrial markets needed to strike a balance between reducing anti-competitive conditions and allowing for sufficient economies of scale can only be accomplished in the medium term. But reducing policy-induced and institutional barriers to entry of new private sector competitors can--and should--be implemented in the short run. Indeed, even where excessive horizontal and vertical structural dominance remains, facilitating free entry can help make such markets contestable and provide strong pressures to compel competitive performance from incumbents. Equally important, a rules-based institutional framework for implementing competition policy--at the federal and regional levels--must be established to reduce administrative discretion and corruption, increase transparency and predictability and enhance incentives for accountability.

II. STRUCTURAL DOMINANCE AMONG INCUMBENT FIRMS

At the national level, the degree of concentration of industrial output in Russia suggests an absence of a structural competitive problem. The average 4-firm concentration ratio (the sum of the market shares of the top four producers) is about 60%. For many industries, Russia and the United States have similar 4-firm concentration ratios, and the largest Russian manufacturing enterprises (measured by number of employees) are not unusually large compared to US firms. Indeed what is noteworthy is the lack of *small* firms in Russia.[5] However, this aggregate-level analysis masks three underlying attributes of Russia's industrial landscape.

1. Horizontal Dominance

First, large Russian enterprises tend to be configured as single integrated multi-plant establishments, often located in or near a single city. In contrast, in industrialized economies a given enterprise usually has multiple establishments and they are located across domestic regions and often abroad. In Russia, products as diverse as trolley buses, potato-harvesters, motor scooters, and coal-cutting and tunneling machines--to mention only a few of hundreds--are manufactured only in a single enterprise in the whole of the country. On an establishment basis, the largest Russian enterprises are significantly *larger* than their counterparts in other countries, including the United States. Reliance on conventional measures of national market share and concentration thus likely understate the true extent of horizontal dominance in many Russian markets. Data on 328 firms in a 1997 World Bank-Russian Academy of Science (WB-RAS) survey[6] reveal that the average market share at the oblast level is 43%. Recent data on concentration indicate that at the oblast level, the average 4-firm concentration ratio is above 95%.

In large part, the existing level of horizontal dominance in Russian manufacturing markets is a legacy of Soviet centralized planning. Horizontal integration is also increasing. But less so through *de novo* expansion than through mergers and acquisitions. The recently announced mergers among aluminum companies and the earlier proposed mergers of oil companies are cases in point. Horizontal integration is also increasing through the creation of financial industrial groups (FIGs). The WB-RAS survey found that enterprises with higher market shares are more likely to be registered as members of a FIG; indeed, the average oblast market share of firms associated with a FIG was 53%, while the average oblast market share for firms not associated with a FIG was 42%.

Surprisingly, empirical investigation of the effects of horizontal dominance on the performance of Russian firms is exceptionally sparse. This is in contrast to the vast literature on this issue for many developed and developing countries, including transition economies. Arguably, this is due to the paucity of comprehensive data on Russian firms in the short period since the onset of reform; and what data do exist suffer from the fact that Russian financial accounting practices diverge from International Accounting Standards. Rectifying this data vacuum and carrying out systematic empirical analysis of such data should be seen as a major challenge to the Russian authorities if policy-making in this area is to be strengthened. In one of the few empirical studies that have been undertaken, support can be found for the notion that, as in other countries, in Russia, the greater the level of market concentration the higher are industry profits.[7] The same study found that capital intensity is negatively related to profitability. Data from the WB-RAS survey indicate that firms with lower capital productivity are more likely to be registered as "dominant" (generally defined as having market shares above 35%--see below) by the Ministry of Anti-Monopoly Policy and Support for Entrepreneurship (MAPSE). Worker productivity also appears to suffer from horizontal dominance. To take but one example, the 100,000 workers at the automobile firm GAZ, which is one of the more innovative large-scale businesses, produced 220,417 vehicles in 1997, compared to the 125,000 workers at Chrysler that made 2 million cars. Goskomstat data of 800 enterprises reveals that firm size is negatively correlated with sales revenue per employee (see Appendix).

2. Vertical Integration

Second, many of the dominant enterprises in Russia are also highly vertically integrated (or have exclusive buyer-seller relationships). Excessive levels of vertical integration superimposed on (horizontally) concentrated product markets can foreclose the entry of rival firms. The high degree of observed vertical integration largely reflects inertia of the uncertainties and chronic shortages of the old Soviet supply system. Engines for trucks are still made only by the Zavolzhye engine factory and bought only by the GAZ vehicle factory. Heavy locomotives are still produced only by the Novocherkassk electrical equipment factory, and the output is purchased completely by the Railways Ministry. Vertical integration is also increasing, occurring usually through mergers and acquisitions rather than through *de novo* expansion. In the oil industry Tyumen Oil was created in 1995, bringing together oil production associations, refinery operations, and oil product marketing firms. Vertical integration also is increasing through the creation of industry-led (as opposed to bank-led) FIGs. A case in point is ALKOR, which encompasses aluminum smelting, production and distribution of finished products. Data from the WB-RAS survey reveal that 46% of the firms indicated that their customers purchased supplies from only 1 or 2 suppliers, and that 23% of the suppliers control more than 65% of the relevant input market

To be sure, there are economies of scale and a savings in transactions costs in combining successive stages of production under one corporate roof. The classic case of continuous steel-casting is well-known: it would be economically inefficient (if not technologically unfeasible) to have three separate firms heating iron ore, rolling it into ingots, and then finishing them into steel products. But in most industries such efficiencies exist only up to a point. Indeed, in the vast majority of markets throughout the world it is increasingly cheaper for a firm to buy inputs (or sell outputs) on the open market or through arms-length contracts rather than producing them internally. In Russia, it appears that due to the hazard of market transactions and because enforceable contracts are still nascent, there are strong incentives for vertical integration. As in the case of assessing the degree and implications of horizontal dominance, empirical investigation of vertical business linkages in Russian manufacturing should be a priority for policy makers.

3. Regional Market Segmentation

Third, significant political economic power is wielded by regional authorities in Russia. This manifests itself in the tight control of important economic activities *within* a region's boundaries. Such control, in combination with enterprise vertical integration, helps to freeze the high degree of structural autarky engendered under the Soviet system, where consumer goods production was a local responsibility and enterprises served only their respective local markets. Worse, it strengthens administrative--as opposed to economic--geographic market boundaries, and fosters the regional segmentation of the Russian economy, diminishing the establishment of a unified economic space, vigorous inter-regional competition and exploiting natural economies of scale.

There are a variety of practices local authorities exercise to limit the inter-regional movement of goods and services. *Tariffs* are charged on the import or export of certain agricultural products in Ulianovsk, Belgorod, Sverdlovsk and Orlov oblasts, among others. There also is an increasing trend of regional *duties* being collected on the importation of vodka and other alcoholic beverages. Many of the same locales maintain regional-level *price controls* on some agricultural products. Businesses using migrant workers are often charged *registration fees* by local governments, which add to the costs of production and inhibits labor mobility. Regional authorities also grant special *tax or credit preferences* to build local business champions. *Arbitrary licensing* of one kind or another is also pervasive, and provincial authorities often create local monopolies by granting single licenses. Indeed examination of the wholesaling system shows a continuation of exclusive distribution patterns that largely remain from the central planning system: privatized wholesale organizations continue to distribute mainly to and from the same customers they served in the old days. In short, large *public* monopolies have been turned into large *private* monopolies that are now working closely with government. In this regard, it is telling that in recent years some of the most frequent violations that MAPSE has dealt with were abuse of market dominance and anti-competitive actions by local governments.[8]

III. BARRIERS TO NEW ENTRANTS

According to official estimates, in 1997 seventy percent of Russia's GDP came from the private sector, up from less than 10% just five years earlier at the start of reform. This is a remarkable achievement. But the main source of the expansion of the Russian private sector remains the privatization process. The creation of private *de novo* businesses in Russia is exceptionally weak and continues to lag far behind the pace of other transition economies, especially in Eastern Europe and the Former Soviet Union (EE/FSU). The lack of effective entry by new private firms is a missing critical ingredient in Russia's enterprise reform program.

1. Who Are The New Private Entrants in Russia?

A World Bank 1996 random survey of Russian firms of all ownership categories indicates that 58% of *de novo* firms in the private sector are owned by managers, 26% are owned by individuals ("outsiders"), and 6% are owned by workers. The owner-manager firm--mainly small and medium size enterprises (SMEs)--appears to be the dominant form for private *de novo* Russian enterprises. SMEs were virtually eradicated in Russia during the Soviet period, more so than in any other EE/FSU country, and mushroomed again only in the late 80s. While the SME sector grew very fast in the early years of Russia's reform, in the last few years growth has slowed dramatically, and may even have ceased.

There are 845,000 registered SMEs in Russia, generally defined as business establishments with less than 250 employees (of which "small" firms are defined by law as establishments with less than 100 employees). This is four times the number a decade ago. Most SMEs operate in services, trading and public catering. SMEs employ about 13% of the Russian labor force, and produce about 12% of GDP; however, these figures are likely to be inaccurate since much small business activity is still in the informal economy and thus goes largely unreported. Still the fact remains that in comparison with other countries in the region, Russia's SME growth has been severely limited. The percentage of national employment accounted for by SMEs in the Czech Republic is 37%; in Georgia 58%, and in Macedonia 37%; SMEs account for 53% of US employment, 80% of Italy's employment, and 69% of France's employment. Importantly, the geographic distribution of SMEs in Russia is highly skewed. Whereas Moscow accounts for 22% of all SMEs, and St. Petersburg accounts for 10%, 28 subjects of the Federation each account for only about 0.5% of the total.

2. Constraints On New Entrants

Economists distinguish between different types of structural entry barriers: those that are (i) *economic* in nature, principally determined by technology or market forces, and those that are (ii) *institutionally-determined* or *administratively-induced.* The need for policy intervention to deal with economic barriers generally arises only when such barriers are (a) chronically high and (b) in markets where there is already significant horizontal or vertical dominance; this is best decided on a case-by-case basis. For institutionally-determined or administratively-induced entry barriers, the case for policy intervention is more clear-cut.

Economic Barriers to Entry

In certain industries, the technology fundamental to the production process naturally gives rise to economies of scale, where unit costs decline as output expands to meet market demand; in such industries these *scale economies* are a barrier to entry since it is unlikely that multiple businesses can all attain the minimum efficient scale to be commercially viable. There are likely to be significant scale economies in certain segments of the infrastructure monopoly sectors in Russia (as elsewhere). However, in most of the manufacturing sector, scale economies are unlikely to be as pronounced relative to market demand and thus, absent policy-induced constraints, such economic barriers to entry are likely to relatively modest, and some in cases, relatively low. This is true in Russia as it is worldwide. *Product differentiation* becomes an entry barrier when incumbent firms enjoy brand loyalty among consumers, making it difficult for potential rivals to become commercially viable because of the need to invest heavily in advertising and/or by charging significantly lower prices. Like many other transition countries, to date brand loyalty among Russian firms is not strong and product differentiation is unlikely to be an entry barrier. The advantages that come with the successful diffusion of *innovation* can also serve to prevent new entry. Much depends on the embedded technological prowess of firms and on whether there is a patent system in place that helps to protect and reinforce that prowess through the granting of exclusive production and marketing rights. As in most transition economies, technological innovation is not a an impediment to entry in Russian industry, and there does not exist an effective patenting system. If anything, entrants displaying technological prowess have an easier time entering Russian markets. Finally, there is the case where *endowments of natural resources* can act as an entry barrier. During an industry's development, firms that locate and exploit such deposits first will have a strategic market advantage over those seeking entry later (unless or until new resource deposits are discovered or the initial firms decide to license otherwise exclusive access rights). Norilsk Nickel is a case in point.

Institutional and Administrative Barriers to Entry

Evidence from Russia suggests that the principal institutionally or administratively determined constraints on entry by the *de novo* private sector are: (i) discrimination with regard to business licensing and registration; (ii) blocked access to (state-owned) warehousing and distribution channels; (iii) a harsh and uncertain regulatory regime (changing "rules of the game") with weak mechanisms for dispute resolution; (iv) difficulty in obtaining suitable business premises and real estate; (v) corruption and organized crime; (vi) poor access to seed capital and competitively priced bank credit; and (vii) a large tax burden, including high rates, multiplicity and complexity, and lack of stability, predictability and transparency. Many of these impediments have been (and in some cases still are) present in other transition countries in the region, including the Czech Republic, Hungary, Poland and Ukraine, especially in the early stage of the transition process. Although the empirical evidence of the impact of such barriers in Russia generally comes from surveys, there does not exist sufficient systematic data to determine the relative importance of each of these constraints; carrying out an empirical investigation to make this determination is critical for policy making.

Registration and Licenses. Although the business license process varies among Russia's regions, the average new business applicant must deal with 20-30 agencies and receive 50-90 approved registration forms. There are 30 different kinds of licenses for a business start-up. In the WB-RAS survey, 12% of the firms indicated that in the past year they had applied for a new license but had been unsuccessful. The survey also found that firms that are part of unregistered FIGs are more likely to fail at obtaining a license than firms that are part of registered FIGs. Thirty four percent of the surveyed firms indicated they were forced to obtain a license that in their opinion was not legally required, and 13% indicated their enterprises paid license fees in excess of what is legally required. Against this backdrop, it is not surprising that the licensing process is fertile ground for corruption (see more below). An anecdote that one entrepreneur paid $7,000 equivalent for a license, of which only $800 equivalent went to government, is not atypical. Firms that specialize helping new businesses navigate the registration process have become a new growth industry. On average to start up a new business in Russia an entrepreneur must spend from 5,000 to several 100,000 New Rubles.

Warehousing and Distribution Networks. While private entry has taken place in retail and commercial activities, the state owned sector still plays a major role in distribution. Moreover, outside the major 2-3 Russian cities, there are either very poor or non-existent warehousing facilities. The situation is particularly acute for refrigeration facilities, placing severe handicaps on transshipment of perishable products across regions. The physical condition of inter-city roads is significantly poor, often far below that found in other countries in the region, making long-haul trucking an extremely expensive and difficult mode of transportation. Railroad freight rates have traditionally been high in order to subsidize rail. passenger traffic. Potential entrants in the distribution and warehousing sector confront not only the usual licensing and other policy-induced start-up difficulties facing any new business in Russia, especially entry barriers posed by neighboring local administrations, but also must deal with organized crime, which is quite active in this sector.

Corruption. Surveys indicate that corruption as a barrier to entry in Russia is pervasive; virtually all firms pay bribes to tax inspectors, customs officers and a host of local bureaucrats.[9] Indeed cross-country evidence suggests that Russian SMEs operate in a business environment that may be worse than most transition economies. On average it takes four times as long to establish a small enterprise in Moscow than it does in Warsaw, that Russian SMEs are subjected to twice as many yearly inspections than their Polish counterparts, and that the number of regulatory agencies involved in SME development in Russia is half again as many as there are in Poland. A recent OECD survey reveals that SME managers in Russia are subject to manipulation by local authorities of 40 to 50 tax rates and deductions. But official taxes are not the only levies new Russian businesses have to pay. Many small enterprises have to pay the mafia to survive. The local press is replete with stories of entrepreneurs paying for a "roof" (*krysha*) for protection. One story reported that mafia levies commonly start from 5% of profits but are often higher, and are usually collected as a flat monthly fee. There is also the threat of violent crime against entrepreneurs: in the WB-RAS survey, 16% of the General Directors indicated they are "very worried" about becoming a victim of violent crime.

Capital Barriers to Entry. In almost any country it is difficult to persuade banks or other financial institutions to back a start-up business; in transition economies, where capital market imperfections are pronounced and institutions that intermediate savings into investment capital are typically nascent, the problem is particularly acute. Like many other countries in the region, in Russia bank loans for new businesses—if they are available at all—are short-term, typically for 6 months term, and expensive. As a result, most SMEs are started from personal savings. According to the State Committee on Small Business, only 15% of small businesses in Russia in recent years have received bank credits. Mortgages are not widely practiced and there are only initial steps in leasing equipment. The emergence of FIGs in Russia can be interpreted as a response to capital market imperfections;

evidence indicates that firms that are members of FIGs are less dependent on internal funds to finance investment expenditures than are unaffiliated firms.[10]

Dispute Resolution. In Russia (like other transition economies), contracts are hard to verify and enforce. In a word, private property rights are not secure or credible. The lack of efficient methods to resolve commercial disputes substantially increases the cost of entry. Most business people in Russia prefer to resolve differences among themselves rather than bring cases to court. Most importantly, the regulatory regime governing enforcement of compensation for successful plaintiffs collecting debts is weak. This places the burden on the plaintiff for debt collection, where the mafia is often instrumental. Up until recently, plaintiffs have had to pay an advance fee equivalent to 10% of the suit; new rules set the fee at 5%, with fees decreasing as claim size increases. Overall, the major issue is implementation and enforcement of the law.

Land and Real Estate. New startups are hindered by restricted access to commercial real estate due to monopoly ownership and control over urban land by municipal administrations. In theory enterprises have the right to privatize associated land plots; in practice, procedures are unclear. Less than 1% of the land under privatized enterprises has been privatized. Firms cannot realize the value of the land via mortgage, lease, or sale, nor can they restructure effectively by modifying structures since control rights over land flow only from the ownership. The failure to assign clear rights over unoccupied and undeveloped urban land is another restriction. Against the backdrop of the state Duma failing to devise legislatively a comprehensive Land Code that permits private ownership of land, the Government has pursued these objectives through presidential decrees. Implementation of these decrees, however, particularly at the sub-federal level has been weak; and the current land tax system contains disincentives on the part of local governments to sell land under privatized non–land real estate. More progress has been made for establishing the legal framework to ensure leasing and selling of commercial real estate belonging to the federal government takes place under competitive conditions; but such provisions are not mandatory for regional and local governments.

Taxes. Surveys show that all businesses in Russia complain about their tax burden, and that the burden on SMEs is particularly harsh. Although the smallest enterprises benefit from some tax concessions (the size threshold for such benefits varies across locales, and benefits often are subject to negotiation and political connections; statutorily, firms with fewer than 15 employees generally get concessions), most SMEs (above 100 employees) have to pay a profit tax, which ranges from 35% to 38%, and the VAT of 10% to 20%. But it is the sheer number of other taxes--ranging from advertising taxes to computer resale taxes--and the time needed to process the required paperwork on a monthly basis that represent a sizable operating cost, thus threatening the survival of new entrants (see Appendix for a list of the other taxes); taxes also change frequently. One tax consultant to new businesses notes that the requisite tax report requires 30 statements and the VAT instruction has changed 3 times in a 6 month period. That taxes can be negotiated (especially at the local level), reduces the stability, predictability and transparency of the tax regime.

IV. POLICY ASSESSMENT

1. Proactive Policies Towards Incumbents and New Entrants

As market reforms continue, and budget constraints continue to harden—ensuring that the prices firms pay for inputs and charge for outputs are in cash, timely, and free of all subsidies (including direct budgetary subsidies and off-budget sources of support, such as permitting tax arrears and soft bank loans)—inefficient large incumbent enterprises (particularly those still in the state sector) will likely decline in importance. [11] But based on international experience, *proactive* polices are needed to both foster the horizontal and vertical restructuring of such firms and redress the problem of regional market segmentation. The main components of a proactive program are under the general rubric of competition policy. The portion of competition policy that focuses on incumbents includes de-monopolization and dis-integration of dominant firms; prohibiting mergers and acquisitions that reduce the number of sellers and increase structural dominance; penalizing for restrictive business practices, such as collusion, price fixing, predatory pricing to drive out competitors or deter entrants; and protecting consumers from unfair trade and false advertising practices. Worldwide, effective implementation of such policies has proven to be difficult and the record of success is mixed. It is particularly challenging in a large, complex economy such as Russia's. Even with improvements in Russia's competition policy regime (see below), implementation regarding incumbents will take time due to the significant political economy costs that large restructurings will entail.

Reducing structural barriers to entry, which can be done in the short-run, is the other main prong of competition policy. New entrants increase pressure on privatized companies and remaining SOEs. Even when incumbent firms have attained dominance, facilitating entry (or allowing for the credible threat of entry) can help instill competitive performance, especially in markets where sunk costs are relatively small and thus exit can be effected should demand soften. Freeing up entry can help make such markets contestable. Entrants are a source of growth through employment creation, not only due to new business development, but also in providing the absorption capacity as restructured firms shed labor and other resources. Entrants have played such a role in many transition economies. Poland provides strong evidence on this score. Between 1992 and 1995 industrial output in Poland increased by 34%, and private entrants accounted for 2/3 of this increase.[12] Evidence from the vast majority of transition economies indicates that new entrants engender other benefits: they bring modern techniques and entrepreneurship skills; they utilize new plant and equipment; and they employ incentive structures that provide for market-oriented corporate governance practices. Reducing entry barriers through greater openness to imports and foreign direct investment (FDI) is especially critical. Yet while liberalization toward imports and FDI can be the primary tool of competition policy in small open economies, such as the Baltics, for the larger transition economies, such as Russia, trade and FDI policy reform must be coupled with other policies to enhance structural competition within the *domestic* market. Empirical evidence shows that even in the tradable sectors this is true: without competitively structured distribution networks, the impact of import competition is significantly muted because distribution services are location-specific, and thus trade and FDI become segmented by geography and transportation costs.

2. Reform of Russia's Competition Policy Framework

Russia, like many EE/FSU countries, has modeled its competition statues on those found in industrialized market economies, including the EU and the US. In addition, Russia, again like most EE/FSU countries, concentrates its efforts to encourage new entry through programs that provide financial support for the development of SMEs; less attention is given to achieve this objective through systematic policies to remove regulatory and institutional entry barriers.

Russian Competition Policy Toward Incumbent Firms. Russia's State Anti-Monopoly Committee (GAK) was founded in 1990; it was given ministerial status in 1995; it was transformed into MAPSE in late 1998 (subsuming the GAK, the Committee on Small Business and the previous independent regulatory bodies overseeing transport and communications). Including its approximately 80 regional branches, the MAPSE is in charge of enforcing several anti-monopoly statutes. A major component of the MAPSE's program is the maintenance of a register of "dominant" firms, where "dominance" is generally defined as at least a 35% market share. In its initial years, the GAK classified thousands of firms as dominant at the federal and regional levels, and regulated these firms' prices, profits and output. The approach has been heavily criticized both inside Russia and by international experts because of its questionable economic rationale and unwieldy procedures, including its tenuous method for defining geographic and product market boundaries and justifiable costs. In 1997 the federal section of the GAK dominant firm registry included about 500 industrial enterprises, accounting for roughly 20% of all industrial output. At present, MAPSE oversight of prices and profits of dominant firms is less one of direct regulation and more of preventing anti-competitive pricing--both the charging of prices above competitively determined levels and of predatory and entry-deterring prices. However, the problems of a poorly clarified economic rationale and unwieldy procedures remain largely intact. With regard to mergers, prior approval of the MAPSE is required for acquisitions of more than 20% of the shares of a company, or acquisition of shares in any firm included in the register of dominant firms. Current rules specify two tiers of dominance: proposed mergers that result in 65% market share are *per se* "undoubtedly dominant"; for proposed mergers that result in market share between 35% and 65%, the MAPSE bears the burden of proof that the merger would result in a "dominant" firm.

Surveys suggest that the MAPSE generally has been reluctant to enforce the law in clear cases of market abuse. In the WB-RAS survey, more than 30% of the respondent General Directors indicated that producers colluding to fix prices are not subject to sanctions under the anti-monopoly law. Political economy constraints and excessive use of discretionary--as opposed to rules-based--authority seem to be a major factor in preventing effective enforcement. The decline in industrial output during Russia's transition has made it difficult to take actions against important industrial enterprises. Case evidence reveals that regional MAPSE branches have had a tendency to protect local champions rather than act as part of a *federal* anti-monopoly system. At the same time, many observers have concluded that although the MAPSE has an adequate statutory basis to be effective, it lacks the resources, skill base and information to deal sufficiently with prevailing anti-competitive problems.[13]

Russia's Promotional Policies for New Entrants. The policy framework for encouraging entry is focused on SMEs. Russian federal legislation supporting SME development dates back to 1993, when a Support Fund for Entrepreneurs was created that provided for short-term credits. A two-year holiday on profit taxes also was established. Subsequently, regional and local support funds were created, and it is at these levels that the bulk of SME support is implemented. In 1995 the State Committee for the Support and Development of Small Businesses was created (and as noted above, in 1998 it was subsumed under MAPSE). The Committee is charged with coordinating the allocation of support to SMEs, largely in the form of low-interest credits from Federal, regional and international sources, as well as technical assistance from the latter. New laws also have been enacted to foster the development of SMEs, including one in 1995 that defines eligibility limits on SME size ("small" enterprises have no more than 100 employees), allows SMEs to pay only a single tax on income, and to take advantage of other incentives, including accelerated amortization. However, licensing, registration and accounting problems at that the regional and local levels have prevented most SMEs to avail themselves of the law's benefits. In 1997 a new federal small business support program was initiated for small ventures to grow to one million, and the work force to expand by 3 million by 2000. Long-term plans call for SME contribution to the economy to double to account for 25% of GDP with the number of workers involved to increase to 25-30 million.

Principles for Reform. Competition policy in most transition countries has been similar to Russia's experience. It has focused more on deterring anti-competitive conduct (through establishing price controls), rather than dealing with imperfections in market structure. It is not surprising that progress has been slow, since establishing effective competition policy involves considerable institutional building and the development of specialized skills. Countries that have made more, but still mixed, progress in implementing competition policy--largely the industrialized economies such as the EU and US--have given emphasis to (i) actively dismantling excessive horizontal and vertical dominance; (ii) preventing anti-competitive mergers through the implementation of clearly defined and widely publicized merger guidelines; (iii) establishing credible, sizable criminal sanctions against collusion and price fixing; and (iv) significantly reducing policy-induced impediments to new entry. They also have (v) rules-based competition policy agencies with effective implementation authority, resources, and well-trained staff. [14]

With respect to promotion of SMEs, as a general rule there is no economic rationale for policy to favor a particular business ownership form or size. At a minimum, a policy of neutrality is called for. This in itself would suggest a reorientation of the policy regime to reduce the bias against SMEs and eliminate the regulatory and institutional barriers to entry in the Russian economy. On the other hand, in Russia (as in other transition economies), where market failures are pronounced, SMEs generate, perhaps uniquely, positive externalities that can address these market failures. As noted earlier, by dint of their size and their ability to fill easily market niches, SMEs offer a source of flexibility in business development. This is needed especially in the process of transition where experimentation is critical. Evidence from other countries suggests that whereas initially SMEs tend to occupy the retail sector, over time SMEs have become significant players in manufacturing. Because SMEs represent employment outlets for a rational downsizing of the public sector they add to stabilization. Finally, growth in the SME sector is characterized less in terms of expansion of incumbent firms (which is typical for growth in the large-firm sector) and more in terms of *de novo* entry and the introduction of new products and processes. It is on these grounds that a regime to financially promote SME development can be justified. However, such a regime should have not only *limited objectives* and be *transitory,* but it also should be seen as *a supplement* to policies that eliminate regulatory and institutional barriers to entry. International experience is replete with examples that small business promotional programs often lead to the creation of new bureaucracies that survive years beyond their useful lives.

3. Policy Recommendations

Policies Toward Incumbents

Make Structurally Dominant Markets Contestable for New Entrants. Despite progress in recent years, Russia still faces the challenge of designing a robust enforcement regime to deal with horizontal and vertical structural market imperfections among incumbent industrial firms. Rather than devoting scarce economic and political resources for direct regulatory oversight of day-to-day pricing conduct of "dominant" firms in the manufacturing sector, the immediate focus should be on eliminating regulatory and institutional barriers to entry for new competitors (specific actions are outlined below). In short, creating contestable market conditions should be the first line of offense in compelling competitive performance, not the creation of more elaborate regulatory pricing schemes. MAPSE's "dominant" firm registry and related regulations on profit margins and output should be abandoned immediately. Moreover, in reducing administrative and institutional barriers to entry, priority attention and resources should be directed toward those markets where there is already significant structural dominance; other markets can be dealt with subsequently. In addition, reduction of entry barriers must be focused not only on creating favorable conditions for new competitors domiciled *within* a regional market, but also on creating such conditions so that potential competitors based in *other* geographic markets can sell or invest in the regional market in question. This is critical to neutralize the regional segmentation of markets. It means that stronger enforcement authority must be realized at the *federal* level to deal with the anti-competitive practices of local governments.

Develop Comprehensive Merger Guidelines. Resources should also be directed at preventing further horizontal and vertical consolidation through mergers and acquisitions in markets where structural dominance and autarky are already excessive. This should be the first of line of defense. Initiatives here can build on MAPSE's current system regarding assessment of mergers. But more explicit and well-defined merger guidelines should be developed and announced that establish general policy parameters for distinguishing between pro-competitive and anti-competitive mergers based on similar guidelines used in industrial countries, such as the EU and the US. The blanket application across all markets of the current cutoffs of 35% and 65% has little economic rationale; refinements are needed to take into account the underlying technology of the production process, and product and geographic market boundaries. Public announcement of the guidelines is critical to maximize transparency, credibility and predictability of the merger/acquisition policy regime so as to not hinder a "market for corporate control" and the rechanneling of assets to higher values in use. Merger applicants should know ex ante they have to meet the burden of proof that a merger will enhance efficiency and not result in a significant loss of competition. But a balance must be struck between, on the one hand, prohibiting excessive enterprise integration that engenders the exercise of market power, and on the other, fostering sufficient integration that permits the realization of technical economies of scale and scope. Big business is not always bad. Where existing firms are below minimum efficient scale, integration should not be prevented but rather encouraged. Newly created integrated company structures that span otherwise regionally autarkic markets, including perhaps as a transition device newly established industry-led FIGs, can help ameliorate the existing artificial market segmentation.

Develop Rules-Based Competition Policy Institutions. Experience in both Russia and elsewhere shows that when implemented poorly, i.e., as a new source of discretionary authority, competition policy can do great harm. While Russian competition law is, for the most part, up to par with international standards, the institutional regime for its implementation and enforcement responsibilities is extremely weak and subject to excessive discretion, especially in light of the power and involvement of sub-federal governments in promoting regional industrial policy. Several steps could be taken. The Government at the very highest levels should review the mission of the current MAPSE, with a view towards developing, in consultation with renowned international experts, recommendations to introduce a rules-based competition policy institutional regime at the federal and sub-federal level of government. To institutionally strengthen MAPSE, the agency should be twinned with competition authorities in OECD countries to carry out a series of sectoral appraisals. Consideration should also be given to promoting the establishment of a non-governmental "foundation for competition" whose role is primarily educational initially; in time, it could serve as an ombudsman.

Conduct Comprehensive Empirical Assessment of Horizontal and Vertical Structures. The task of de-monopolization or dis-integration in the industrial sector is a complex one and should be part of the medium term agenda. A prerequisite for any proactive competitive restructuring is comprehensive empirical investigation examining current horizontal and vertical concentration in key product and geographic markets. Efforts here can build on existing Goskomstat data. The investigation should assess the competitive impact of emerging economic agglomerates, including FIGs, in priority sectors.

Policies to Foster New Entry

Implement Rules-Based Streamlined Business Licensing at the Federal and Local Levels. In January 1998 new initiatives were discussed at a Government meeting on the problems of SMEs, including changes in issuing of licenses. But the measures do not address the problem that the setting of license fees is subject to the discretion of local authorities, which results in price discrimination and arbitrary rule. Reforms here are a top priority. They should be based on other countries' experiences and on enacting legislation that sets precise, streamlined limits at all levels of government on the time and money required to get a business license in most sectors, and codifies sizeable criminal sanctions for officials who violate this rules-based system. For certain sectors, such as human health, the environment and national security, more stringent procedures could be applied. (See the Appendix for Ukraine's initiatives.)

Establish Mechanisms to Enforce Private Property Rights and Foster Dispute Resolution. Even when appropriate legislation exists, the courts are unable to enforce procedures and outcomes. It is important to strengthen the legal/judicial framework to allow for secure property rights and adequate contract enforcement. The new bailiff service recently authorized by law (sudebnye pristavy) should be established immediately and given the authority to enforce automatically compliance by losing defendants.

Privatize Warehousing and Distribution Networks and Permit De Novo Entry. While the private sector has developed in the commercial and retail sectors, the state still plays the major role in the wholesale market for distribution of inputs and outputs; yet competition in distribution networks is critical to reducing regional market segmentation. Competitive private ownership, through privatization and new entry, should be permitted at the federal and local levels in warehousing and wholesale distribution activities as a priority measure. Existing franchise prohibitions or privatization limitations on all but truly "strategic" distribution/warehousing entities involving state federal and municipal property should be repealed by law.

Combating Corruption. Many countries have paid increasing attention to the problem of corruption, and the debate on possible policy options is on-going. There is no single solution.[15] Recent insights suggest that corruption arises when institutions have monopoly positions, there is the ability to exercise discretion and incentives for accountability are weak. Additional laws themselves are unlikely to bring about significant reduction in corruption. Effective reform must be directed to changing the system: (i) introduction of independent oversight of agencies; (ii) clarifying and making transparent how much official discretion can be exercised; and (iii) utilizing penalties and rewards for conduct. Russian authorities should give consideration to establishing independent anti-corruption oversight ("watchdog") bodies at the federal and regional levels; models can be found in other countries, such as Hong Kong, Singapore, Botswana, Chile and Malaysia.

Rationalize the Tax Regime. Business taxes can be simplified through the draft Tax Code: (i) reducing the number of taxes and (ii) making tax rules more transparent and less ambiguous. Stability of taxes can be enhanced through: (iii) keeping changes to a minimum and when there are changes, grandfathering existing investments for a fixed period, and (iv) prohibiting retroactive applications of laws and regulations. These changes will help reduce discretion and intervention by local tax officials. Confidentiality of taxpayer information can be ensured through (v) legislation that specifies criminal sanctions for official breaches.

Liberalize Ownership and Access to Land and Real Estate. The Government should renew its commitment to work with the Duma to ensure passage of a comprehensive Land Code for the free transfer, ownership and user rights of land. The Government should also accelerate current efforts to create a state system for registering real estate rights and transactions as well as creating a base of standards for a system by which to ensure rights of ownership of real estate, including the institution of title guarantees and insurance. An assessment of the land tax system should be completed with a view to removing disincentives on the part of local governments to sell land under privatized non–land real estate.

Continue Liberalization of the Trade and Foreign Direct Investment Regime. While much of Russia's trade regime is basically liberal, with average statutory tariff rates below 15%, more progress is needed on liberalizing licensing and other non-tariff barriers on imported goods and services. Early WTO accession, particularly in the trade-in-services area (GATS), could help to introduce "within border" competition in the distribution sector. The Government should continue to bring the policy regime governing FDI in line with international best practice: (i) national treatment for foreign investors; (ii) binding international arbitration for investor-State disputes; (iii) substantial reduction in restricted sectors and limitations on FDI in other sectors; (iv) freedom for profit remittances; (v) expropriation only for a bona fide public purpose and with prompt, adequate compensation; and (vi) and an absence of trade-related-investment-measures (TRIMs).[16]

Promotional Policies for SMEs. Introducing a system of targeted SME support through subsidized lines of credit, is likely to be counterproductive. Such a regime undermines market-based reforms of the banking sector and the strengthening of the commercial intermediation role of banks. Worse, particularly in the context of a weak property rights, it breeds corruption. Support programs that can be helpful include (i) providing equity participation in venture capital and investment funds; (ii) funding of local banks providing commercial based credit to SMEs; and (iii) co-financing with local banks of SME projects. A (iv) government-sponsored "one-stop-shop" information network and clearinghouse of market opportunities and relevant regulations and legislation for SMEs also could be created on a local basis and coordinated at the federal level to ensure consistency nationwide.

APPENDIX

Table 1: Financial Performance of Firms by Size
(as % of sales revenue)

	Large	Medium/Small
Number of Firms	399	401
Employment	489,505	129,620
Avg. No.Employees	1,227	323
Sales revenue	Rb 31,046 mill	Rb 8,844 mill
1. Net income before tax	-1.1	1.3
2. Cash flow	2.7	3.2
3. Net cash flow	-0.8	0.4

Source: Goskomstat database, 1996

Table 2: Barriers to Business Operations in Russia
(percentage of surveyed firms)

Barrier	Very Serious	Somewhat Serious	Not Very Serious	None
Regulation (non-taxes)	9.1	27.4	59.8	3.7
Litigation	28.0	34.8	17.7	19.5
Financing	9.5	14.3	65.5	10.7
Criminal Organizations	33.8	16.5	10.1	39.6

Source: World Bank-Russian Academy of Sciences survey of 328 firms, 1997

Table 3: Taxes and Business Fees in Russia

National Level
Profits tax
Individual income tax
VAT
Contributions to Pension Fund, Social Insurance Fund, Medical Insurance Fund, Employment Fund
Highway users tax
Acquisition tax on motor vehicles
Fuel and lab materials tax
User fee for the use of words "Russia" and "Russian Federation"

Oblast / Republic Level
Business property tax
Fees for educational institutions
Transportation tax
Water charges

Local Level
Tax on maintenance of housing and amenities
Advertising tax
Land tax
Ground rent tax
Computer resale tax
Vehicle resale tax
License fee for holding auctions
User fee for use of local symbols
Levies on stock exchange transactions
Charges for currency sale transactions
Charges for cleaning of human settlements
Vehicle parking fees
Police service taxes
Levies on the right to trade
Liquor distribution license fees

Source: The Russia New Business Development Project, Deloitte Touche Tohmatsu International, June 1997

Box 1: Kiev Lessens Red Tape of Registration

In February 1998, Ukraine enacted a law streamlining the registration and licensing process for businesses to drastically reduce the time and money required to get a business running. Foreign investors have long complained that Ukraine's labyrinthine licensing requirements were a major deterrent to investment and development of small- and medium-size business. Under the new law, the licensing process is to take no more than five days for most types of businesses to obtain seven basic licenses. Previously, new firms had to get more than 90 licenses for about 1,000 types of business activities. This took at least several months and required visits to more than 30 ministries and up to 800 municipal bodies. Senior Government officials concede the previous process presented opportunities for authorities to demand bribes for each document Under the new law, limits will continue only for businesses that have to do with "human health, the environment and national security." Businesses subject to stricter permits are in the mining, arms, pharmaceuticals, tobacco, alcohol, gambling, legal, auditing, insurance, medical, transportation, education, tourism and telecommunications sectors.

Source: Moscow Times, February 4, 1998

ENDNOTES

1 The focus of this paper is Russia's manufacturing sector; it does not address the infrastructure monopolies (what the Russian authorities refer to as the "natural monopolies"). This article draws from H.G. Broadman, 1999a.

2 See H. G. Broadman, 1998. As of January 1998 more than 130,000 enterprises had been privatized in Russia since 1992. There are approximately 29,000 federally-owned enterprises and institutions, of a total of 88,000 state owned enterprises nationwide.

3 See, for example, H. G. Broadman, 1995, 1996, and 1999b, and World Bank 1997a.

4 In addition, barriers to exit through the bankruptcy process remain high (see Mirsky, 1999); corporate governance structures and incentives diverge from market principles (see Broadman, in press); and a substantial portion of transactions is carried out through barter and non-monetary instruments (see Hendley, Ickes and Ryterman, 1999).

5 See, for example, P. Joskow, R. Schmalansee, and N. Tsukanova, 1994.

6 Analysis of these data was carried out by the author and James Anderson.

7 See A. Brown and J. Brown, 1998.

8 These problems are exacerbated by transport considerations. The opportunity cost of transportation was not considered in enterprise location decisions during the Soviet era. Site choices were made on the assumption that government would subsidize the transportation sector. The resultant strain of that legacy today is exacerbated by the fact that over 90 percent of domestic Russian freight is transported by rail (compared with 50 percent in the US and 30 percent in Western Europe). This is only partly a result of the country's large size: many freight shipments cover only a short distance. The condition and coverage of the road system remain exceedingly poor. Trucks are used only for intra-city freight. This means that if firms wish to change suppliers or customers, they must find alternate shipping arrangements.

9 See T. Frye and A. Shliefer, 1996; and World Bank 1997b.

10 See E. Perrotti and T. Gelfer, 1998.

11 In most transition economies in the region, including Russia, there is a clear downward trend in budgetary subsidies; in 1996 these averaged about 1% of GDP for EE/FSU countries. In the WB-RAS survey, 9% of the firms indicated they received direct subsidies; 23% indicated they receive tax exemptions or tax holidays. As budgetary subsidies have been eliminated, tax arrears and inter-enterprise arrears in some EE/FSU countries have risen dramatically. In Russia, tax arrears in 1997 were more than 10% of GDP. The Government is attempting to accelerate and expand its efforts to collect delinquent tax payments--including interest and penalties--from large tax debtors. These actions need to be implemented not only at the federal but also the regional levels.

12 See Gomulka 1997.

13 See B. Slay 1998.

14 Several east European and Baltic countries have been developing competition policy and institutions broadly consistent with EU guidelines in these areas. In 1997 Estonia, Hungary, Latvia and Romania adopted new competition laws or new administrative structures in line with EU standards. There have also been signs of active enforcement of competition legislation in the Czech Republic, Hungary, Poland, Slovenia and the Baltic countries on terms of case reviews, recommendations and fines, although few significant actions to limit the exercise of market power have been taken.

15 See R. Klitgaard, 1998; and C. Gray and D. Kaufmann, 1998.

16 For recent analysis of Russian trade and FDI policy and suggestions for reform, see Broadman 1999c.

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